CHAPTER 10

REFORM TAXATION OF FINANCIAL INSTITUTIONS

Part A. Commercial Banks and Thrift Institutions

This Part discusses proposals to conform special rules relating to the taxation of banks and thrift institutions to the general rules for the taxation of corporate income. The special bad debt reserve deduction for banks and thrift institutions would be repealed. Interest allocable to tax-exempt obligations held by banks, savings and loans, and certain other thrift institutions would be nondeductible. The tax exemption of credit unions would be repealed in the case of large credit unions. Finally, special rules concerning reorganizations of certain thrift institutions and net operating losses of depository institutions would be repealed.

REPEAL SPECIAL RULES FOR DEPOSITORY INSTITUTION BAD DEBT DEDUCTIONS

General Explanation

Chapter 10.01

Current Law

In general, taxpayers may deduct bad debts in the year in which they become wholly or partially worthless or may create a bad debt reserve and deduct a reasonable addition to the reserve each year. Although subject to this general rule, commercial banks and thrift institutions are also permitted to deduct additions to reserves for bad debts using methods unrelated to their actual loan loss experience. These methods for computing additions to reserves for tax purposes bear no relationship to regulatory requirements for bad debt reserves or to the present value of the expected future loan losses.

Commercial banks may utilize either the percentage method or a modified version of the experience method for determining their bad debt deductions. The percentage method allows a current deduction for additions to reserves sufficient to maintain a tax reserve of up to 0.6 percent of eligible loans outstanding. The experience method for banks generally is based on average loan losses over the most recent six-year period. Banks need not be consistent in their choice of method from one taxable year to another. The provision permitting use of the percentage method is scheduled to expire at the end of 1987, at which time all commercial banks must use the experience method.

Thrift institutions may use modified versions of the percentage method or experience method available to banks. Alternatively, thrift institutions, if they hold sufficient amounts of their assets in certain eligible investments (primarily residential mortgages), may elect the percentage of taxable income method for purposes of establishing their bad debt reserves for qualifying real property loans. Savings and loan associations and stock savings banks must hold at least 82 percent of their total assets in eligible investments to receive the maximum deduction, which is equal to 40 percent of taxable income (computed with certain modifications). A lower percentage of taxable income is deductible if less than 82 percent of total assets constitute eligible investments. Mutual savings banks must hold at least 72 percent of their total assets in eligible investments to receive the maximum deduction, which is also subject to reduction if the percentage of eligible investments is less than 72 percent.

Loans which become wholly or partially worthless during a taxable year are charged against the reserve. This charge reduces the reserve and, under the percentage of eligible loans or experience methods, increases the amount that must be added to the reserve to restore it to an appropriate level.

Thrift institutions that utilize the percentage of taxable income method are limited in the amounts of certain other tax benefits they may claim. For example, they may claim only one-half of the otherwise-allowable investment tax credit and their dividends-received deduction is reduced from that available to other corporations.

The corporate preference item reduction provisions reduce the amount of bad debt reserve deductions that a depository institution not on the experience method may claim. No deduction is allowed for an amount equal to 20 percent of the excess of a depository institution's addition to its bad debt reserves over the additions that would have been deductible had the institution used the experience method. In addition, an amount equal to 59-5/6 percent of such excess constitutes a tax preference item for purposes of the corporate minimum tax.

Reasons for Change

The deduction for additions to a bad debt reserve essentially allows a deduction for debts that become worthless during the taxable year and a deduction for any net increase in the tax reserve. The deduction for the increase in the tax reserve represents a deduction for future loan losses, without any discount for the present value of such losses. A deduction for future losses defers taxable income, which either increases depository institutions' after-tax income or enables then to offer lower loan rates.

Current law provides more favorable tax treatment of bad debt losses to depository institutions than to lenders in other industries. The experience reserve method favors fast-growing banks and banks with worsening loss experiences. The percentage of eligible loans method favors fast-growing banks and banks with low loan loss experience. Moreover, the methods permitted depository institutions for computing additions to tax reserves bear no necessary relationship to actual loan losses.

This tax preference distorts the investment decisions of some depository institutions. A thrift institution may utilize the favorable percentage of taxable income method only if it specializes in residential mortgage lending. The maximum deduction is available only if 82 percent of the thrift's assets (72 percent for mutual savings banks) are invested in loans on residential real estate, liquid assets, or certain other assets. The linkage between a lower effective tax rate and residential mortgage lending provides a disincentive to diversification by thrift institutions and thereby subjects thrifts to increased portfolio risk.

Finally, the special percentage of taxable income deduction benefits only profitable thrift institutions. Thrifts with no taxable income must elect the percentage of eligible loans method to maximize their net operating losses. Thus, the special bad debt deduction tied to residential mortgage lending benefits only a fraction of all mortgage lenders.

Proposal

The special rules for commercial banks and thrift institutions for computing additions to a bad debt reserve would be repealed. Depository institutions would be subject to the general rule applicable to all taxpayers. The Administration proposals would require generally that bad debt losses be deducted only as they occur. See Ch. 8.04. This requirement would apply equally to commercial banks and thrift institutions.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986. To prevent a double deduction for debts that become partially or wholly worthless after the effective date, depository institutions would generally be required to include existing tax reserves in income ratably over ten years, starting with the first taxable year beginning on or after January 1, 1986. Alternatively, a depository institution could elect to include existing tax reserves in income in the first taxable year beginning on or after January 1, 1986. A special transition rule would be provided for thrifts with existing tax reserves determined in whole or in part under the percentage of taxable income method. Thrifts would recapture only the greater of the tax reserve computed under the experience or percentage of eligible loans methods. Any existing excess tax reserves would not be recaptured.

Analysis

Taxpayers are generally not allowed to deduct future liabilities or losses until they occur. Any reserve method for computing bad debt deductions is based on expectations as to future losses to some degree. If tax reserves for future losses were allowed, a neutral tax reserve system would limit the deduction to the estimated present value of the future loss. Thus, it is proposed that for all taxpayers the deduction for a reasonable addition to a reserve for bad debts would be repealed. Additional analysis of the proposed repeal of the reserve method for all bad debt deductions is provided in Chapter 8.04.

Under current law, deductions for additions to reserves for bad debts are overstated for depository institutions compared to deductions for bad debts for other businesses. Because a bad debt reserve for tax purposes involves only bookkeeping entries with no set-aside of assets, the only practical effect of present law is either to increase the after-tax income of depository institutions or to enable depository institutions to offer loans at artificially low rates. The proposal would eliminate these distortive effects.

The proposal would reduce the amount of bad debt deductions reported by depository institutions. Present law permits depository institutions to select from a variety of methods the one providing the largest deductions. For example, the percentage of eligible loans reserve method permits a bank to maintain a tax reserve equal to 0.6 percent of its outstanding loans without regard to actual loss experience. Thus, it only benefits banks with bad debt experience rates below that level; banks with higher bad debt rates will utilize the experience reserve method. In 1983, an estimated 73 percent of commercial banks found the percentage method to be more beneficial (actually, more used it because of special transition rules), while only 27 percent found the experience method to be more advantageous.

Excess deductions for additions to bad debt reserves by thrift institutions under the percentage of taxable income method reduce their effective marginal tax rates. Most thrift institutions were unable to take advantage of the percentage of taxable income method in 1981 and 1982 because they did not have taxable income. Only profitable thrift institutions derive any benefit from the percentage of taxable income method permitted under current law. For example, the total bad debt deductions claimed by savings and loan associations fell from $1.41 billion in 1979 to $0.14 billion in 1981, because the preferential tax treatment is tied to profits, not actual loan losses. In 1983, an estimated 60 percent of savings and loans found the percentage of taxable income method to be beneficial (actually, fewer did because of net operating loss carry forwards), while the remaining 40 percent found the percentage of outstanding loans method to be more beneficial.

Ninety-seven percent of all savings and loan associations and 64 percent of all commercial banks had loss-to-loan ratios below the percentage method's allowable 0.6 percent. Also in 1983, 99 percent of all savings and loan associations and 58 percent of all commercial banks wrote off for financial reporting purposes less than 0.6 percent of their outstanding loans. The special bad debt reserve rules are a significant subsidy for depository institutions and substantially distort the measurement of their income.

Depository institutions must establish reserves to meet regulatory requirements. Regulatory agencies properly seek to preserve the safety and soundness of depository institutions by requiring conservative levels of actual reserves. Historically, the tax rules for computing deductions for additions to tax reserves have been unrelated to reserve requirements imposed by regulatory agencies. Under current law, deductions for additions to a bad debt reserve do not reflect additions to actual reserves, only a reduction in tax liability. The tax accounting rules for bad debts should be designed to measure income accurately. Thus, depository institutions, as with other taxpayers, should be restricted to deducting losses when they occur.

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Existing tax reserves reflect previous deductions for future losses. If the reserves are not brought back into income and deductions are allowed, then some loan losses would be deducted twice. The portion of the thrifts' tax reserves in excess of what they would have taken under the commercial bank method is not brought back into income because it was a special subsidy for investments in residential mortgages. The proposed transition rule draws down existing tax reserves over a 10-year period. This rule is substantially more favorable than requiring future loan losses to be charged against the reserve until the reserve is exhausted.

Finally, in response to the original Treasury Department proposal, some commentators suggested that the deduction for bad debts be based on the additions to the reserve maintained for financial accounting and regulatory purposes. Such a reserve, based on generally accepted accounting principles ("GAAP"), is said to reflect economic income more accurately than the specific chargeoff method because, it is argued, additions to a reserve based on GAAP reflect current diminutions in the value of the loan portfolio while the specific chargeoff method delays the deduction until a time after the loss has actually occurred. The suggestion to recognize reserves based on GAAP was not adopted because any reserve system is inevitably based to some extent on expectations as to future losses. The more accurate method to determine the amount and timing of the appropriate deduction for bad debts in a taxable year is to judge the loss which has occurred by examining the loan portfolio at the close of the taxable year based on the facts and circumstances known at that time. It is also important to note that, if a deduction were permitted based on additions to a GAAP reserve, an interest charge on recoveries attributable to loans for which an addition to the reserve was made might be appropriate.

DENY DEDUCTION FOR INTEREST TO CARRY TAX-EXEMPT BONDS

General Explanation

Chapter 10.02

Current Law

Current law generally denies a deduction to any taxpayer for interest on indebtedness incurred or continued to purchase or carry tax-exempt obligations. Whether indebtedness is incurred or continued to purchase or carry tax-exempt obligations is based on the taxpayer's purpose in incurring indebtedness while holding tax-exempt obligations, as indicated by the facts and circumstances of the particular case.

Until 1982, banks, thrifts, and certain other financial institutions could invest their depository funds in tax-exempt obligations without losing the deduction for interest paid on their deposits or short-term obligations. Under current law, however, such financial institutions are denied 20 percent of their interest deduction allocable to indebtedness (including deposits and other short-term obligations) incurred or continued in order to purchase or to carry tax-exempt obligations acquired after 1982. For this purpose, a statutory presumption treats a portion of a bank's or other financial institution's indebtedness as allocable to tax-exempt obligations in an amount equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired after 1982) held by the bank or financial institution to (ii) the average adjusted basis over the year of all assets held by the bank or financial institution.

Reasons for Change

Basic measurement of income principles require that income be matched with the costs of its production. In line with these principles, the costs of producing tax-exempt income, including interest expense incurred to carry tax-exempt bonds, are properly nondeductible. Since the income to which such costs are attributable is exempt from tax, disallowance of a deduction is necessary to prevent the taxpayer from offsetting other nonexempt income.

The exception from the above principles for interest paid or incurred by commercial banks and thrifts has enabled these institutions to hold a substantial portion of their investment portfolios in tax-exempt obligations, substantially reducing their Federal tax liability. The full allowance of interest deductions to banks holding tax-exempt obligations contributes to the relatively low effective tax rates of banks. In 1981, prior to the changes reflected in current law, commercial banks paid only $926 million of Federal income tax on approximately $15 billion of net income.

In addition, the special rule for commercial banks and thrifts provides them with a competitive advantage over other financial institutions that are disallowed interest deductions for carrying tax-exempt obligations. Brokers and dealers currently are not allowed to deduct any portion of the interest paid to purchase or to carry tax-exempt securities. Similarly, life insurance companies must prorate their tax-exempt investment income between policyholders and the company, which is comparable to denying a deduction for interest incurred to carry tax-exempt obligations.

Proposal

Banks, thrifts and the other financial institutions favored under current law would be denied a deduction for 100 percent of their interest payments allocable to the purchase or carrying of tax-exempt obligations. The portion of a financial institution's interest payments that would be deemed allocable to the purchase or carrying of tax-exempt obligations would be the same as under current law. Thus, such portion would be equal to the ratio of (i) the average adjusted basis over the year of all tax-exempt obligations (acquired on or after January 1, 1986) held by the financial institution to (ii) the average adjusted basis over the year of all assets held by the financial institution. For example, if a bank holds $1,000,000 of tax-exempt bonds acquired after January 1, 1986, (measured by their average adjusted basis over the year) and $3,000,000 of other assets (similarly measured), its otherwise allowable interest deduction would be reduced by 25 percent without regard to whether paid to depositors, short-term obligors, or long-term obligors. As under current law, the prorata presumption would be irrebuttable.

Effective Date

The proposal would be effective for interest allocable to tax-exempt obligations acquired on or after January 1, 1986. The current disallowance rule of 20 percent would continue to apply after December 31, 1985 to tax-exempt obligations acquired between January 1, 1983 and December 31, 1985.

Analysis

The deductibility of interest paid to purchase or to carry tax-exempt bonds increases the attractiveness of tax-exempt obligations because of the attendant opportunity to shelter other taxable income. Moreover, present law encourages banks to make investments that are not economically attractive except for the tax benefits. For example, a bank may borrow at a nine percent interest rate and invest in tax-exempt obligations yielding only seven percent interest. Economically, the bank would lose two percent on the transaction; however, because the bank can deduct 80 percent of the interest paid, it pays an after-tax interest rate of only 5.7 percent (9 x [1 - (.46 x .8)]) and makes an after-tax profit of 1.3 percent. Denying banks a deduction for interest allocable to the purchase or carrying of tax-exempt obligations would eliminate a tax incentive to make an otherwise unattractive economic investment.

Commercial banks hold one-third of outstanding tax-exempt securities and loans, as shown in Table 1. Commercial banks are the largest institutional investors, and are second only to households in total holdings of tax-exempt obligations. Commercial banks are the major institutional investors because of their ability to borrow funds and deduct interest to carry investments that earn tax-exempt income. The transitional rule would continue to allow banks to deduct interest attributable to bonds acquired prior to the effective date, so that there would be no incentive to sell existing holdings. Banks would continue to buy some tax-exempt bonds after the effective date as evidenced by the current holdings of life insurance companies and brokers and dealers, who are already subject to the proposed rule.

Together with the reduction in marginal tax rates, this proposal would tend to reduce demand for tax-exempt bonds and exert upward pressure on tax-exempt interest rates, particularly short-term yields. Several of the Administration proposals, however, would have the opposite effect on the interest rates of tax-exempt obligations. The aggregate impact on tax-exempt interest rates is uncertain because the elimination of nongovernmental tax-exempt bonds, bonds issued for arbitrage purposes, and other tax shelters would tend to increase demand for the remaining governmental bonds and exert downward pressure on the interest costs paid by State and local governments.

Table 10.02-1

Distribution of Tax-Exempt Securities and Loans -- 1983

	Outstanding Tax-Exempt Bonds Amount (In Billions)	Percent
Households	$ 173.8	35.9 %
Nonfinancial Corporate Businesses	4.2	0.9
State and Local Government General Funds	9.7	2.0
Commercial Banks	162.4	33.5
Savings and Loan Associations	0.9	0.2
Mutual Savings Banks	2.2	0.4
Mutual Funds	31.5	6.4
Life Insurance Companies	10.0	2.1
State and Local Retirement Funds	1.8	0.4
Other Insurance Companies	86.7	17.9
Brokers and Dealers	1.4	0.3
Total	$ 484.6	100.0 %

Office of the Secretary of the Treasury May 28, 1985

Source: Board of Governors of the Federal Reserve System, Flow of Funds Accounts, Assets and Liabilities Outstanding, 1960-83.

REPEAL TAX EXEMPTION FOR LARGE CREDIT UNIONS

General Explanation

Chapter 10.03

Current Law

Credit unions are exempt from tax on their income, whether such income is retained or distributed to depositors.

Reasons for Change

Because of their tax exemption, credit unions enjoy a competitive advantage over other financial institutions such as commercial banks and savings and loan associations. The tax-exempt status of credit unions has enabled them to grow rapidly since 1951, when savings and loan associations and mutual savings banks became subject to the corporate income tax. Since 1962, credit unions have enjoyed a 13 percent annual growth rate in financial assets, compared with an 11.1 percent rate for savings and loan associations, 9.4 percent for commercial banks, and 7 percent for mutual savings banks. Due to expanded powers and faster growth, credit unions accounted for 10.8 percent of total consumer credit (not including mortgages) in 1983 compared with 6.6 percent in 1962.

In an economy based on free market principles, the tax system should not provide a competitive advantage for particular commercial enterprises. Credit unions thus should generally be subject to tax on the same basis as other financial institutions.

These arguments apply with particular force to large credit unions, which are substantially equivalent to commercial banks and thrifts. Most credit unions, however, are relatively small. Over 80 percent of all credit unions have less than $5 million of gross assets. Revoking the tax-exempt status of small credit unions would impose a significant administrative burden for a relatively small revenue increase.

Proposal

The tax exemption for credit unions with assets of at least $5 million would be repealed. Such large credit unions would be subject to tax under the same rules that apply to other thrift institutions. Credit unions with assets less than $5 million would continue to be exempt from tax.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

Tax exemption at the company level allows customer/owners in credit unions to defer tax liability on earnings retained by the credit union. By retaining their earnings tax-free, credit unions can offer their customer/owners higher rates of return than other financial institutions. Repealing the tax exemption of credit unions would eliminate the incentive for such credit unions to retain, rather than distribute, current earnings.

In 1983, Federal credit unions earned $4.0 billion in net income and distributed $3.6 billion in dividends or interest refunds to customer/owners. Retained earnings, which are tax-exempt and accrue tax-free interest income, were 10.6 percent of current net earnings. The proposal is limited to credit unions with assets of at least $5 million because, while approximately 82 percent of all credit unions (13,020 out of a total of 15,877 credit unions) in 1983 had assets less than $5 million, the credit unions above this threshold accounted for approximately 80 percent of retained earnings for all credit unions.

The proposal would subject large credit unions to tax on their retained earnings. To the extent that retained earnings are necessary for growth, large credit unions would have to increase the spread between their "dividend" rates and loan rates to cover the Federal tax liability in the same manner as stock companies. As with other mutual depository institutions, however, large credit unions could reduce the amount of Federal income tax paid at the corporate level by distributing more "dividends" to depositors or by providing lower loan rates to borrowers. Distributions of earnings would be included in taxable income currently at the individual level.

REPEAL REORGANIZATION RULES FOR FINANCIALLY TROUBLED THRIFT INSTITUTIONS

General Explanation

Chapter 10.04

Current Law

Certain acquisitions of the stock or assets of one corporation by another qualify as tax-free reorganizations under current law. In general, the shareholders of a corporation that is acquired in a reorganization may exchange their stock for stock of the acquiring corporation on a tax-free basis. In addition, a corporation acquired in a reorganization may exchange its assets on a tax-free basis for stock of the acquiring corporation.

Corporate acquisitions generally do not qualify as tax-free reorganizations unless they satisfy the "continuity of interest" requirement. Stated generally, an acquisition will satisfy the continuity of interest requirement only if the shareholders of the acquired corporation receive a significant, continuing equity interest in the acquiring corporation.

Special rules enacted in 1981 permit the acquisition of a "financially troubled" thrift institution to qualify as a tax-free reorganization without regard to the continuity of interest requirement. The continuity of interest requirement would generally pose an obstacle in such an acquisition because depositors are the only persons holding interests in the financially troubled thrift who would receive an interest in the acquiring corporation. Because of their insured position, however, the depositors in the failing thrift generally will not accept an equity interest in the acquiring corporation with its attendant risk of loss. For this reason, the acquiring corporation ordinarily will assume the failing thrift's liabilities to its depositors. In the absence of the special waiver, an interest as a depositor would not satisfy the continuity of interest requirement.

For the special rule to apply, the Federal Savings and Loan Insurance Corporation ("FSLIC"), Federal Home Loan Bank Board ("FHLBB"), or, where neither has supervisory authority, an equivalent State authority, must certify that the transferor thrift is insolvent, that it cannot meet its obligations currently, or that it will be unable to meet its obligations in the immediate future. In addition, the transferee must acquire substantially all of the transferor's assets and must assume substantially all of its liabilities. If an acquisition of a failing thrift institution satisfies these rules, the acquiring corporation succeeds to the tax attributes of the failing thrift, including its net operating losses and a carryover basis in its assets.

In addition to the special reorganization rule, present law provides an exclusion from income for payments by the FSLIC to a thrift institution in connection with a reorganization. Such payments are not included in the thrift's gross income and do not reduce the thrift's basis in any of its assets.

Reasons for Change

The special rules governing reorganizations of financially troubled thrift institutions were enacted in 1981 to facilitate mergers and reorganizations of the ailing thrift industry. In such acquisitions, a profitable financial institution typically agrees to assume a failing thrift's obligations in consideration for payments from a regulatory body, such as the FSLIC, and the right to utilize the failing thrift's tax losses and assume the thrift's basis in its assets, which typically consist primarily of mortgage loans with a book value substantially in excess of market value.

Thrift institutions and their shareholders should be subject to tax on the same basis as other business enterprises. The special rules for reorganizations of financially troubled thrift institutions are essentially in lieu of increased assessments by the FSLIC on all thrifts for deposit insurance and effectively shift some of the burden of thrift losses to the Federal government. If such subsidization of thrifts is necessary, it should be effected through direct appropriations. This would permit the appropriate regulatory agency to determine the need for and amount of a subsidy on a case-by-case basis.

Proposal

The special reorganization rules for acquisitions of financially troubled thrifts and the exclusion from income of FSLIC payments to thrift institutions in connection with a reorganization would be repealed.

Effective Date

The repeal of the special reorganization rules would be effective for acquisitions occurring on or after January 1, 1991. The repeal of the exclusion for certain FSLIC payments would apply to taxable years beginning on or after January 1, 1991; payments made on or after January 1, 1991, pursuant to an agreement entered into before that date would be exempt.

Analysis

The special reorganization rules are in lieu of increased assessments of the thrift industry for deposit insurance and, thus, are an inappropriate subsidy for a particular industry. In addition, Federal assistance provided through special tax rules hides the total subsidy cost and is likely to exceed the amount of assistance that would otherwise be provided through direct appropriations.

Nevertheless, the Administration recognizes that the thrift industry has not fully recovered from the economic conditions which prompted Congress to enact the special reorganization rules in 1981. Moreover, the FSLIC will require a transition period within which to seek authorization to charge sufficient premiums for deposit insurance. Therefore, repeal of the special rules is not proposed to be effective until January 1, 1991. In the interim period, most of the below market loans currently jeopardizing the financial stability of many thrifts will be repaid and the FSLIC may seek authority to assess more realistic deposit insurance premiums. Increased assessments will place the burden of thrift losses on the industry, rather than on taxpayers generally.

REPEAL SPECIAL RULES FOR NET OPERATING LOSSES OF DEPOSITORY INSTITUTIONS

General Explanation

Chapter 10.05

Current Law

Taxpayers may generally carry net operating losses ("NOLs") back to the three taxable years preceding the loss year and forward to the succeeding fifteen taxable years. Commercial banks and thrift institutions, however, may carry NOLs back ten taxable years and forward to the five succeeding taxable years. The extended carryback period makes it more likely that a NOL of a depository institution will result in a current refund.

Reason for Change

The underlying premise of allowing a corporation to offset a NOL incurred in one year against taxable income earned in another year is to provide an averaging device to ameliorate the unduly harsh consequences of a strict annual accounting system. No justification exists, however, for distinguishing between NOLs of depository institutions and NOLs of other businesses.

Proposal

The special carryback and carryover rules for banks and thrifts would be repealed.

Effective Date

The proposal would be effective for NOLs incurred in taxable years beginning on or after January 1, 1986. Losses incurred in taxable years before the effective date would be subject to the rules of current law.

Analysis

Losses incurred by depository institutions should be treated in the same manner as losses of other taxpayers. Under current law, a depository institution is more likely to obtain a current benefit from a NOL than other taxpayers. There is no reason of tax or economic policy for granting favorable treatment in this regard to depository institutions.

Part B. Life Insurance Companies and Products

The current Federal income tax treatment of life insurance companies and their products allows investors in such products to obtain a substantially higher after-tax return on the investment portion of such products than is available on investments whose income is fully taxed on a current basis. The Administration proposals would do away with this special treatment. Deferral of tax on the investment income earned on a life insurance policy (other than a term insurance policy) would be ended by taxing to the policyholder the annual increase in the cash surrender value of the policy. The same treatment would apply to annuity contracts.

Special rules that reduce the income tax paid by life insurance companies would also be modified. The life insurance reserve for any contract would be limited to the contract's net surrender value. The special 20-percent life insurance company deduction and 60-percent small life insurance company deduction would be repealed.

IMPOSE CURRENT TAXATION ON LIFE INSURANCE INSIDE BUILD-UP

General Explanation

Chapter 10.06

Current Law

The premium paid on any life insurance policy (other than a term insurance policy) can be divided into three components: a pure insurance component, a loading component, and an investment or savings component. During any period, the pure insurance component of a policy serves to redistribute funds from policyholders who pay charges for insurance protection to beneficiaries of policyholders who die during the period. The loading component serves to cover the insurance company's expenses and to provide it with a measure of profit. The investment component of a policy arises from the fact that the company can invest funds paid by policyholders between the time the funds are received by the company and the time they are paid out to beneficiaries. The company in turn credits fixed or variable amounts to the policy, thereby increasing the cash value of the policy and providing a return to the policyholder on his investment in the policy.

Thus, a policyholder who pays a premium in excess of the cost of insurance and loading charges for the year in which the premium is paid is, in effect, making a deposit into a savings account that earns income for the benefit of the policyholder.

Current law permits life insurance policyholders to earn this income on amounts invested in the policy free of current tax. This untaxed investment income is commonly referred to as "inside build-up." The company issuing the policy is allowed a deduction for increases in its insurance reserves. Because the level of reserves relating to a policy increases as investment income is credited to the policy, the reserve deduction effectively shields the investment income from tax at the company level.

If a policy fails at any time to satisfy a Federal tax statutory definition of life insurance, which requires that the policy have a significant insurance component, the policy is treated as a combination of term life insurance and an investment fund, with the income generated by the fund being currently taxable to the policyholder.

Any amount paid under a life insurance policy by reason of the death of the insured is excluded from the gross income of the beneficiary. Thus, if a policyholder holds a life insurance policy until his death, the investment income on the policy, which was not taxed when credited to the policy, escapes tax permanently. If a policyholder surrenders his life insurance policy before death in exchange for the policy's cash surrender value or receives distributions in the form of policyholder dividends, the policyholder recognizes ordinary income equal to the excess of the cash received over his net investment in the policy. The policyholder's investment in the policy includes the portion of his premiums that has been used to pay the cost of life insurance for past periods. Consequently, any investment income taxed to the policyholder is reduced by the cost of his life insurance, even though this cost is a personal expense of the policyholder and would not be deductible if paid directly.

Reasons for Change

The deregulation of financial institutions and various economic factors have resulted in an increase in the rate of interest paid on traditional investment products (e.g., bank accounts and whole life insurance policies) and a proliferation of competing investment products offered by different types of financial institutions. The effect of these changes has been to increase the already substantial investment orientation of cash value life insurance products. Although the definition of life insurance places some broad limits on the use of life insurance as a tax-favored investment product, it is still possible to design an insurance policy meeting this definition under which the cumulative investment earnings at currently prevailing interest rates are projected to be as much as eight times as large as the cumulative insurance costs. Thus, the favorable tax treatment of inside build-up on life insurance policies can be obtained through a contract that provides a relatively small amount of pure insurance coverage.

Earnings on comparable investment products generally are not tax free or tax deferred. Instead, income credited on such investments generally is subject to tax whether or not the income is currently received by the taxpayer. For example, taxpayers generally are subject to current tax on interest credited on certificates of deposit although the interest is not received until the certificate of deposit matures, and on investment income from mutual funds even if the income is credited in the form of additional fund shares.

Moreover, life insurance is not subject to the significant limitations on the timing and amount of contributions, withdrawals, and loans that apply to other tax-favored investments, such as qualified pension plans and individual retirement accounts (IRAs).

The benefit of deferring or avoiding tax on the inside build-up on life insurance policies goes only to individuals with excess disposable income that enables them to save, and particularly to individuals in high tax brackets. This benefit is not available to individuals buying term insurance since it derives solely from the investment component of a policy (which is not present in a term insurance policy).

The tax-favored treatment of inside build-up encourages individuals to save through life insurance companies rather than other financial institutions and perhaps to purchase life insurance that they would not buy except to gain access to the favorable tax treatment of the investment income. This distorts the flow of savings and investment in the economy.

Proposal

Owners of life insurance policies (other than variable life insurance policies) would be treated as being in constructive receipt of the cash surrender value (taking into account any surrender charge or penalty) of their policies. Thus, a policyholder would include in interest income for a taxable year any increase during the taxable year in the amount by which the policy's cash surrender value exceeds the policyholder's investment in the contract. A policyholder's investment in the contract would be equal to the aggregate of his gross premiums, reduced by the aggregate policyholder dividends and other distributions under the policy and by the aggregate cost of renewable term insurance under the policy. In the case of variable life insurance policies, the policyholder would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable policy. The policyholder thus would not be taxed on the unrealized appreciation of assets underlying a variable policy. Any explicitly stated surrender charges would be an offset to realized gains and other income.

Effective Date

The proposal would be effective for all inside build-up credited on or after January 1, 1986 to policies issued on or after the date of adoption by the House Ways and Means Committee or the Senate Finance Committee of this proposal. Inside build-up would continue to be free from tax in the case of policies issued before the date of Committee action to the extent that the death benefit of the policy does not exceed the death benefit on the date of Committee action plus any additional death benefit required for the policy to continue to satisfy the definition of life insurance under current law.

Analysis

Taxing the inside build-up on life insurance policies would eliminate the largest tax distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would promote the efficient flow of long-term savings.

Taxation of inside build-up also would eliminate the need under current law for complex rules and restrictions in several areas, including the determination of tax liability when a policy matures or is surrendered and the definition of contracts that qualify as life insurance.

Table 1 shows the distribution of cash value life insurance policies by family economic income. High-income families are more likely to have cash value policies as well as larger policies. The average annual tax-deferred income earned on life insurance and annuity policies in 1983 is estimated at $3,050 for families with income greater than $200,000 and less than $200 for families with income less than $30,000. Because the purchase of life insurance policies for predominantly investment purposes is a recent development, the difference between the amount of inside build-up earned by wealthier individuals and that earned by less wealthy individuals is expected to grow in the future.

Table 10.06-1

Distribution of Ownership of Cash-Value Life Insurance Policies and the Annual Inside Interest Build-up 1/ By Economic Income - 1983

Family Economic Income	Percentage of Families with Cash-Value Life Insurance Policies	Average Annual Inside Buildup 2/
$ 0 - 9,999	13 %	$ 85
10,000 - 14,999	25	110
15,000 - 19,999	33	135
20,000 - 29,999	41	190
30,000 - 49,999	53	310
50,000 - 99,999	68	520
100,000 - 199,999	78	1,240
200,000 or more	70	3,050
All Families	42 %	$ 355

Office of the Secretary of the Treasury May 28, 1985

1/ Includes annuities.

2/ For those with policies.

IMPOSE CURRENT TAXATION ON DEFERRED ANNUITY INVESTMENT INCOME

General Explanation

Chapter 10.07

Current Law

Income credited to a deferred annuity contract is not taxed currently to the owner of the contract or to the insurance company issuing the contract. In general, amounts received by the owner of an annuity contract before the annuity starting date (including loans under the contract) are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is taxed as ordinary income based on the ratio of the investment in the contract to the total distributions expected to be received. Penalties are imposed on certain premature distributions under an annuity contract.

Reasons for Change

Investment income earned on deferred annuities is similar to investment income earned on other savings instruments with other financial institutions. Interest on savings accounts and certificates of deposit and investment income from mutual funds is taxed currently, however, while investment income earned on annuities is not taxed until withdrawal. Moreover, deferred annuities are not subject to the significant limitations on the timing and amount of investments that apply to other tax-favored investments, such as pension plans and individual retirement accounts ("IRAs"). Yet deferred annuity savings are more likely than other tax-favored investments to be withdrawn before retirement because of the smaller and more easily avoided withdrawal penalty.

Since tax-favored annuities can be purchased only from life insurance companies, this tax deferral directs the flow of savings toward life insurance companies and away from other financial institutions. There is no reason to favor savings through insurance companies over savings through competing financial institutions.

The deferral of tax on investment income credited to deferred annuities is available only to persons with disposable income available for savings and is of greatest benefit to persons in the highest tax brackets. The tax deferral thus favors wealthier individuals.

Proposal

Owners of deferred annuity contracts (other than variable contracts) would be treated as being in constructive receipt of the cash value (taking into account any surrender charge or penalty) of their contracts. Thus, the owner would include in income for a taxable year any increase during the taxable year in the amount by which the contract's cash value exceeds the owner's investment in the contract. In the case of variable deferred annuity contracts, the contract owner would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable contract. The owner thus would not be taxed on the unrealized appreciation of assets underlying a variable contract. Any explicitly stated surrender charges would be an offset to realized gains and other income.

Effective Date

The proposal would be effective for all investment income credited on or after January 1, 1986 to contracts issued on or after the date of adoption by the House Ways and Means Committee or the Senate Finance Committee of this proposal. In the case of contracts outstanding before the date of Committee action, investment income credited to the contracts would continue to be untaxed until withdrawal or distribution of funds from the policy. The penalty imposed on premature distributions under a deferred annuity contract would be repealed for distributions from contracts issued on or after the date of Committee action. All of the other provisions prescribing special treatment of distributions under annuity contracts before the annuity starting date would become obsolete as annuities containing untaxed investment income are surrendered or mature.

Analysis

Taxing the investment income credited to deferred annuity contracts would eliminate a major distortion in the financial services area and would place competing financial products and institutions on more equal footing. This would encourage the efficient flow of long-term savings.

LIMIT LIFE INSURANCE COMPANY RESERVE DEDUCTION

General Explanation

Chapter 10.08

Current Law

The gross amount of premiums received by a life insurance company is included in the taxable income of the company. As described in Ch. 10.06, the premium paid on any life insurance policy (other than a term insurance policy) can be divided into a loading component, a term insurance component, and a savings component. The savings component of a premium is held, in effect, for the benefit of the policyholder in an account yielding an investment return. The savings component is needed to help fund the higher cost of insurance protection in later years and is currently available to the policyholder in the form of the policy's cash surrender value.

Life insurance companies are allowed a deduction from taxable income for any net increase in life insurance and other reserves and must include in income any net decrease in reserves. The life insurance reserve for any contract is the greater of the net cash value of the contract (taking into account any surrender penalty or charge) or the reserve for policy claims determined under a prescribed set of rules (based on prevailing State regulatory requirements) relating to the reserve method, assumed interest rate, and assumed mortality or morbidity rate. These latter rules attempt to measure the amount needed to fund the anticipated excess of the present value of future claims and benefits to be paid under the policy over the present value of future premiums (if any) to be received under the policy. The reserve deduction thus serves to adjust the company's income to account for its liability to pay, in the event of a surrender of the policy, the cash value or, in the event of a claim under the policy, the face amount of the policy.

Reasons for Change

Like the receipt of savings deposits by a bank, the receipt of the savings component of life insurance premiums should not be taxed to the company. However, the remaining portions of the gross premiums -- the loading component and the term insurance component -- should be taxed to the company, with corresponding deductions for sales and administrative costs and the payment of claims. Thus, if gross premiums are included in the gross income of the company, an offsetting deduction for the savings component of the premiums is appropriate.

The allowance of a reserve deduction for the increase during the taxable year in the greater of the policy's cash surrender value or the reserve for policy claims often will overstate the company's reserve deduction, especially in the initial years of the policy.

This is because the reserve for policy claims, i.e., the estimate of the excess of the present value of future claims and benefits over the present value of future premiums, is calculated using conservative assumptions required for State regulatory purposes.

A reserve deduction equal to the increase in the cash surrender value of a policy generally would be sufficient to exclude the savings component of gross premiums from the company's taxable income and allow a deduction for the exact amount of interest credited to the policyholder's savings account. Moreover, the policy's cash surrender value is an objective measure of the reserve for policy claims needed by the company. This is because the cash surrender value is, in effect, the amount the company is willing to pay to the policyholder if he gives up his right to claims and benefits under the policy.

The initial overstatement of reserves allowed under current law results in tax deferral and a reduced effective tax rate for life insurance companies. This enables life insurance companies to offer policyholders higher rates of return on savings or lower costs of insurance, thereby attracting investment dollars from other financial institutions.

Proposal

For tax purposes, the life insurance reserve for any contract generally would be limited to the net cash surrender value of the contract (taking into account any surrender penalty or charge). A special rule would be provided for current annuity contracts that may not be surrendered for cash.

Effective Date

The proposal would be effective for policies sold on or after January 1, 1986.

Analysis

Restricting life insurance companies' deductions for additions to reserves to the increase in the cash surrender value of policies issued by the company would be consistent with the separation of income and liabilities of other financial institutions. The actual amount of the savings deposits included in life insurance premiums effectively would be excluded from taxable income. Similarly, the actual amount of interest credited to policyholders would be deducted by the company and, as proposed in Ch. 10.06, included in the income of the policyholders. This would eliminate the different tax treatment of savings at the company level between life insurance companies and depository institutions.

Life insurance companies would increase their premiums (or earn lower profits) as a result of any increased tax liability resulting from the more accurate measurement of their taxable income.

REPEAL SPECIAL LIFE INSURANCE COMPANY DEDUCTIONS

General Explanation

Chapter 10.09

Current Law

All life insurance companies are allowed a deduction equal to 20 percent of their otherwise taxable income. In addition, a small life insurance company is allowed a deduction equal to 60 percent of the first $3 million of its otherwise taxable income. This deduction phases out as otherwise taxable income increases from $3 million to $15 million. The small company deduction is allowed only to companies with gross assets of less than $500 million. Consolidated group tests generally are used in applying the taxable income and gross asset standards.

Reasons for Change

The special deduction for all life insurance companies was enacted to reduce the competitive impact of the Tax Reform Act of 1984, which broadened the tax base of life insurance companies without similarly broadening the tax base of competing financial institutions. Enactment of comprehensive tax reform affecting all financial institutions and reducing the maximum marginal tax rate would eliminate the justification for the special deduction for life insurance companies. Retention of the special deduction for life insurance companies would be unfair to their competitors and would cause tax-induced economic distortions.

Similarly, the special deduction for small life insurance companies was a deviation from the proper measurement of economic income to prevent a dramatic increase in the tax burden of small life insurance companies as a result of the 1984 Act. After comprehensive tax reform, special rules for small life insurance companies would no longer be appropriate.

Proposal

The special life insurance company deduction and small life insurance company deduction would be repealed.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The revision of the tax rules governing life insurance companies in 1984 essentially broadened their tax bases and reduced their effective marginal tax rates. The 20 percent deduction of otherwise taxable income lowers life insurance companies' effective maximum marginal tax rate to 36.8 percent. The Administration proposals would lower the top corporate rate to 33 percent. Repeal of the special 20 percent deduction provision would be more than offset by the reduction in the maximum corporate tax rate.

Small life insurance companies would be placed on a par with all other small corporations. Elimination of preferential tax rates based on the size of the firm (other than the graduated rates made available to small corporations generally) would reduce tax-induced distortions that favor sales of life insurance through small firms.

Part C. Property and Casualty Insurance Companies

This Part discusses proposals to curtail favorable tax rules for property and casualty ("P&C") insurance companies. The system of reserves for unpaid losses would be revised to assure correct treatment of the underwriting and investment income earned by P&C companies. Special provisions that reduce the effective tax rate on P&C companies would be eliminated. Specifically, the deduction for contributions to a protection against loss account would be repealed. Special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed. The deduction for policyholder dividends by mutual P&C companies would be limited in conformity with the deduction allowed mutual life insurance companies.

REVISE TREATMENT OF LOSSES BY PROPERTY AND CASUALTY INSURANCE COMPANIES AND ALLOW DEDUCTION TO CERTAIN OF THEIR POLICYHOLDERS

General Explanation

Chapter 10.10

Current Law

Property and casualty ("P&C") insurance companies are allowed a reserve deduction for "losses incurred" during a taxable year. The deduction includes the company's estimate of "unpaid losses," whether or not unpaid losses have accrued under normal tax accounting rules. Unpaid losses include amounts that will be paid in connection with claims filed with the company during the taxable year as well as amounts that relate to claims expected to arise from events occurring during the taxable year that have not been reported to the company. The deduction for these claims generally is not discounted to reflect the fact that they will not be paid until some time in the future. Moreover, the reserve does not grow over time to reflect the investment income earned on the reserve. A company is also permitted to set up an unearned premium reserve for premiums received during one taxable year that relate to coverage to be provided in subsequent years.

In the case of taxpayers who sustain losses, the tax treatment of the losses depends upon a number of factors, including whether the loss is a business or a personal loss, whether the loss is to the person or property of the taxpayer or is a tort or other liability to a third party, and whether the loss is covered by insurance. First, most personal losses are nondeductible. For example, individual taxpayers can claim a deduction for casualty losses to personal property only to the extent the losses exceed ten percent of the individual's adjusted gross income; deductions for medical expenses are limited to those in excess of five percent of adjusted gross income. Second, otherwise deductible tort and similar liabilities to a third party generally are not treated as incurred (and hence are not deductible) until payment is made to the third party. Third, although certain uninsured losses sustained by a taxpayer are deductible at the time the loss is incurred, no deduction is allowed at this time if the loss is insured. In general, no account is taken of the taxpayer's loss of the time value of money resulting from any delay between the time the loss is incurred and the time the insurance claim is paid.

Often, as part of the settlement of a liability to make payments for personal injury damages, a property and casualty company or an uninsured defendant will agree with the injured party to assign the liability to make periodic settlement payments to another person, such as an affiliate of a life insurance company, who will fund the "structured settlement" by purchasing an annuity contract. Third-party assignees who assume other persons' liabilities to make periodic payments as personal injury damages or settlements may exclude from gross income amounts received in consideration for such assumptions, to the extent such amounts are invested in annuity contracts to fund the liabilities. The third-party assignees' basis in the annuity contracts is reduced by the amount of excluded income. Third-party assignees recognize income as they receive payments on the annuity contracts but may deduct periodic payments to the injured parties.

Reasons for Change

The deduction by P&C companies of reserves for claims to be paid in the future, unadjusted for the investment income that will be earned on those reserves, results in deferral of P&C companies' tax liability and reduces their effective tax rates. In other cases where tax deductions for reserves are allowed, either the allowable reserves are discounted for the expected future investment earnings on the reserve funds (as is the case with life insurance reserves) or the investment income earned on the reserve is added to the reserve (as is the case with nuclear decommissioning trust funds).

The current tax treatment of P&C insurance reserves distorts the choice between self-insurance and third-party insurance. P&C companies deduct currently the full amount of the future liability for many casualty losses that would not be deductible currently by a self-insurer. Because a current tax deduction is more valuable than a future deduction, individuals and businesses are encouraged to insure against risks with a P&C company in order to take advantage of this favorable tax treatment.

With respect to persons sustaining losses covered by insurance, current law is inaccurate in failing to recognize the effect of a delay between the time a loss is incurred and the time an insurance claim for such loss is paid. Even a taxpayer who suffers a loss of property that is fully insured for its current fair market value suffers an uninsured loss measured by the loss of the value of the property during the period the incurred loss remains unreimbursed. If the current system of taxing P&C companies were changed without correcting this defect, the tax system would discourage the purchase of insurance with respect to losses that would otherwise be deductible (primarily business property losses and large personal casualty losses).

Finally, in the case of third-party assignees, the current tax treatment of amounts received from assignors and amounts paid to injured parties effectively exempts from tax the investment income on the amount assigned. This exemption is not warranted nor is it required by the exclusion from injured parties' income of periodic payments received as personal injury damages pursuant to structured settlements. That is, the rationale for the tax treatment of injured parties is not to allow them tax-free investment of damage awards, but rather to remove a tax disincentive to injured parties who accept payment in the form of a structured settlement as an alternative to a lump sum. Just as injured parties are taxed on income from the investment of damage awards once received, third-party assignees should be taxed on income from the investment of funds prior to payment to injured parties.

Proposal

The deduction by P&C companies for unpaid losses during a taxable year would be computed under the "qualified reserve account" ("QRA") method. Under this method, the company would establish reserve accounts for claims to be paid in an amount estimated by the company to be sufficient to fund payment of the claims, taking into account the company's estimates of the amount of the claims, the time of payment of the claims, and the company's after-tax rate of return on its investment assets. Separate reserve accounts would be established by line of business and year of policy issuance. In other words, one account would be established for all claims under all policies in a particular line of business issued in a particular taxable year. This account would take the place of the current separate reserve accounts for unearned premiums, incurred but not reported ("IBNR") losses, and reported claims.

The initial amount deductible with respect to a given reserve account could not exceed the combined statutory unearned premium reserve, IBNR reserve, and claims reserves on policies covered by that account. Beyond this, the company would not be subject to federally prescribed rules in establishing the reserve account.

Each reserve established by the company would be increased annually by a percentage equal to the after-tax rate of return actually earned by the company on its investments during that year. To prevent the company's investment income from being sheltered from tax, no additional reserve deduction would be allowed for the annual increase in the reserve accounts attributable to the allocation of investment income.

The after-tax rate of return for a company during a given taxable year would be equal to the total net investment income of the company (including tax-exempt income) for that year, reduced by taxes attributable to that income, divided by the average total surplus and reserves of the company for the year. Thus, in effect, the QRA proposal would prorate the taxable and tax-exempt income among all the reserves and surplus of the company. To the extent a P&C company is able to increase its after-tax income through investment in tax-exempt securities, its reserves would grow more quickly. This would require the company either to take smaller initial reserve deductions or realize greater income from the release of reserves when claims are paid.

The company would be allowed a deduction each year for the full amount paid to satisfy claims, but would be required to include in taxable income an offsetting amount released from the appropriate reserve account. If the reserve was insufficient to cover all claims, the excess claims would be deductible when paid. Conversely, if any amount remained in a reserve account after payment of the last claim in that account, that amount would be included in taxable income.

A company would be permitted to strengthen a reserve it determined was insufficient to cover future claims and a deduction would be given for additional amounts placed into a reserve. However, the company would be required to establish the need for reserve strengthening by a showing of objective factors affecting the amount needed to fund the payment of claims. Such factors would include a strengthening of the company's reserves on its annual statement or a decline in prevailing interest rates. Companies also would be free to release into income additional amounts from reserves it felt to be excessive. This would allow companies to avoid a bunching of income in a single year from the release of an excessive reserve.

A company would not be able to maintain a reserve indefinitely. Rules would be established limiting the maximum life of a reserve, depending on the line of business. Any reserve balance at the end of the maximum life would be released into income. Any subsequent claims under policies covered by that reserve would be deductible when paid.

This proposal would also apply to reserves for unpaid losses not included in life insurance reserves held by life insurance companies. Thus, a life insurance company issuing accident and health policies would be required to use the QRA method to account for unpaid losses on such policies.

Taxpayers suffering losses covered by insurance would be permitted to elect to claim a deduction with respect to those losses without regard to the prospect of recovery from the insurance company. In other words, electing taxpayers would be allowed to deduct the loss in the taxable year the loss is incurred as if the loss were uninsured. Insurance proceeds would be taxable income when received, but an exclusion would be given equal to the amount of any portion of the loss that was not deductible. Current law would continue to apply to nonelecting taxpayers.

Third-party assignees of liabilities to make personal injury damage payments would include the full amount of consideration received from the assignor in gross income. An assignee purchasing an annuity contract to fund its liabilities to an injured party would be treated as the owner of the annuity and would be taxed on the income component thereof. The assignee would be permitted to elect either to treat the purchase of an annuity used to fund its liabilities to an injured party as a deductible expense at the time of the purchase or to treat each payment to the injured party as deductible at the time the payment is made.

Effective Date

The proposal would be effective for all losses incurred in taxable years beginning on or after January 1, 1986 that are insured under policies issued on or after January 1, 1986. The proposal on third-party assignments of personal injury liability would be effective for all assignments entered into on or after January 1, 1986.

Analysis

Under the proposal, P&C companies would still be permitted to use the reserve method to match income and losses occurring in different taxable years. The QRA method, however, would take into account the time value of money. A current deduction of $1,000 is worth considerably more than a future deduction of $1,000 because investment income will be earned on the tax saving produced by the deduction. For the same reasons, less than $1,000 needs to be held in reserve to fund a future liability of $1,000. For example, if interest income accumulates at an after-tax rate of six percent, a reserve of only $792.09 is needed to provide sufficient funds to satisfy a liability four years in the future of $1,000. If a fund of $1,000 is set aside and deducted, it is appropriate to recognize the growth of that fund to $1,262.48 and to include the excess amount of $262.48 in income when the claim is paid.

The system of qualified reserve accounts does not require the discounting of reserves. This feature of the proposal avoids the difficult problem of choosing a mandatory discount rate in an environment where investment returns vary widely from company to company and from year to year. Companies are free to discount reserves using any set of assumptions as to future interest rates (e.g., the assumptions used in pricing the policies) or even to establish undiscounted reserves. This flexibility is possible because the QRA method assures that the ultimate after-tax return that a company realizes on a group of policies does not depend on the amount the company places into the reserve for those policies, assuming that the company's tax rate is constant over time. The company would not have a tax incentive to overreserve since any excess tax deduction would be recaptured when the claims are ultimately paid with an interest factor equal to the company's actual after-tax rate of return on investment assets. Conversely, companies that underreserve would receive additional deductions at the time they pay their claims to ensure that they will not be penalized for underreserving.

This feature of the QRA method is not present in a system that requires <u>pre-tax</u> discounting of reserves and grants additional deductions for investment income earned on reserves. Such a system, while clearly an improvement over present law, would penalize a company for underestimating the amount of a claim or overestimating the length of time until payment of the claim. Conversely, a company would receive a windfall on any claim that was overestimated or whose payment was delayed. More significantly, such a system would continue to undertax P&C companies since investment income on reserves held by P&C companies would not be taxed. Such a system thus fails to tax the entire income of P&C companies and continues the distortionary effect of current tax law that favors third-party insurance over self-insurance.

A substantial portion of the claims paid by P&C companies are paid in years subsequent to the year in which premium income is received and a deduction for losses paid or incurred is claimed. Table 1 shows the average period of loss payment for all insurance written by P&C companies and for several major lines of business. As shown on the table, over 60 percent of all losses of P&C companies are paid after the year of deduction. The actual discounted value of these losses at the time the premium income is received, assuming a six percent discount rate, is approximately 91 percent of their undiscounted value. In the case of medical malpractice insurance, a line of business where long delays in the payment of claims are common, more than one-half of all losses are paid beyond the fourth year after the year of deduction and the discounted value of the losses at the time the premium is received is only approximately 76 percent of their undiscounted value.

It has been argued by some that the present system of undiscounted claims reserves results in "rough justice" since it allows a deduction to some taxpayer in the full amount of an economic loss (of either the policyholder or a third party to whom the policyholder is liable) when the loss is incurred. Arguably, it is proper to match the time of the P&C company's deduction to the time the underlying economic loss is sustained. However, except in the case of business property losses, a large portion of property and casualty liabilities would not be deductible losses to the party suffering the underlying economic loss. To the extent losses would be deductible by the person suffering the loss if uninsured, the proposal would allow a deduction for insured losses and insurance proceeds would be included in income when received. This would achieve a far more accurate result than the "rough justice" arguably afforded by present law, since the taxpayer actually suffering the loss is made whole. Under the current system, a taxpayer suffering the loss is penalized while the policyholders not suffering losses have a windfall to the extent the P&C company passes through its tax benefits in the form of lower premiums. The P&C company also has a windfall to the extent it does not pass through the tax benefits.

The combination of the QRA reserve proposal and the proposed change in the tax treatment of third-party assignees assures that the investment income on amounts set aside to fund structured settlements would be subject to tax. This change would make the tax system a neutral consideration in the choice between structured settlements and lump-sum payments while preserving the current rule that plaintiffs should not have to pay tax on any personal injury damage awards.

The P&C industry may argue that the QRA proposal is not appropriate for an industry with large underwriting losses (-$11.0 billion in 1983). However, the large underwriting losses occur primarily because P&C companies lower premiums (discount) for the future investment income expected to be earned prior to the payment of claims, while the statutory reserves used in calculating underwriting income are not discounted. Total net income is the appropriate

Table 10.10-1

Time Pattern of Loss Payments by Major Lines of Business of Property and Casualty Insurance Companies - 1975 to 1983 Experience

Time Between Payment and Loss	Payments as Percent of Losses Incurred by Line of Business 1/					
	All Policies	Auto Liability	Other Liability	Medical Malpractice	Workers' Compensation	Multiple Peril
Same year	36.7%	36.0%	12.1%	5.8%	27.4%	56.2%
1 year	26.1	29.7	15.6	8.6	24.8	26.2
2 years	10.5	14.4	11.4	9.0	12.7	5.1
3 years	8.3	9.0	13.1	12.1	8.8	4.5
4 years	4.6	4.5	9.9	10.3	4.9	2.3
5 years	3.2	2.6	8.3	10.6	3.6	1.4
6 years	2.4	1.2	7.0	8.1	2.9	1.3
7 years	1.4	0.9	6.5	3.3	1.4	0.7
8 years or later	6.7	1.8	16.2	32.1	13.7	1.6
Present value loss of $100 incurred 2/	$90.56	$92.40	$81.34	$76.28	$87.48	$95.13

Office of the Secretary of the Treasury — May 28, 1985

1/ As an example of how to read this table:
81.6 percent of total losses and loss expense incurred on all policies in 1980 were paid by the end of 1983 (36.7 + 26.1 + 10.5 + 8.3). Only 73.3 percent of total losses and loss expense incurred on all policies in 1981 were paid by the end of 1983 (36.7 + 26.1 + 10.5). Assuming constant payment streams across years, 8.3 percent of losses and loss expense incurred are paid in the third year following the year in which the loss was incurred.

2/ The payment stream discounted at six percent. Assumes payments are made in the middle of the year and discounted to the middle of the first year. The present value is overstated because the payments eight years or later are discounted for only eight years, which would particularly affect medical malpractice, other liabilities, and workers' compensation.

Source: Unpublished tabulations from Schedule P of the insurance companies' annual statement from A. M. Best Company.

measure of company profitability, not underwriting income. Moreover, even in times of overall net losses, the tax system should limit tax losses to properly measured economic losses and should tax profitable enterprises on their properly measured economic income.

The QRA would be only a bookkeeping entry. The QRA reserve system would increase the tax liabilities of P&C companies and affiliated companies but, as described above, the proposal would simply eliminate the deferral of tax liability allowed under current law or impose an appropriate interest charge on the deferral. P&C companies could be expected to increase their premiums to cover any increased tax liability resulting from the more accurate measurement of their taxable income.

The QRA system would not affect State law requirements for reserves to protect policyholders against company insolvency. The amount of tax reserves would be different than the amount of statutory reserves but, because the QRA method does not require the discounting of reserves, tax reserves would not necessarily be lower than statutory reserves. State law presumably would continue to require adequate funding of statutory reserves.

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REPEAL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY PROTECTION AGAINST LOSS ACCOUNT

General Explanation

Chapter 10.11

Current Law

Most mutual property and casualty ("P&C") insurance companies are allowed deductions for net contributions to a protection against loss ("PAL") account. A deduction is generally allowed for contributions to the account in an amount equal to one percent of the losses (both known and estimated) incurred during the taxable year plus 25 percent of the underwriting gain for the taxable year. Companies that have a high percentage of risks relating to windstorms, hail, flood, earthquakes, or similar hazards may defer a larger percentage of their underwriting income.

The portion of the deferred income representing one percent of losses incurred and one-half of the deduction for 25 percent of underwriting income is brought back into income after, at most, a five-year deferral period. The remaining amount, 12.5 percent of underwriting income, continues to be deferred indefinitely, until the company has underwriting losses.

Reasons for Change

The special PAL deduction is unrelated to the measurement of economic income. The PAL deduction is allowed in addition to the full deduction that mutual P&C companies receive for estimates of losses to be paid in the future. Furthermore, the PAL account is simply a bookkeeping entry made for tax purposes; a corresponding reserve account is not required by State regulatory authorities to provide for the financial solvency of the companies.

The tax deferral resulting from the deductibility of contributions to a PAL account reduces the effective tax rate on mutual P&C companies with underwriting income. The lower effective tax rate provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and life insurance companies that offer similar insurance products.

The calculation of the PAL account requires an arbitrary distinction between underwriting and investment income. This distinction increases the complexity of the tax code and increases the possibility that companies will undertake uneconomic transactions solely to minimize tax liability.

Proposal

The deduction for contributions to a PAL account would be repealed. Amounts currently held in the account would be included in income no later than ratably over a five-year period.

Effective Date

The proposal would apply to taxable years beginning on or after January 1, 1986.

Analysis

The benefits of the special PAL deduction accrue largely to profitable companies that do not have underwriting losses and therefore obtain the maximum tax deferral. The special deduction provides little benefit to companies with periodic underwriting losses. Repeal of the special PAL deduction should have minimal impact on premium rates.

REPEAL SPECIAL TAX EXEMPTIONS, RATE REDUCTIONS, AND DEDUCTIONS OF SMALL MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANIES

General Explanation

Chapter 10.12

Current Law

Numerous special rules reduce or eliminate the tax liability of certain small mutual property and casualty ("P&C") insurance companies. Mutual P&C companies with taxable investment and underwriting income of not more than $6,000 are exempt from tax; a limitation on the rate of tax on income in excess of $6,000 phases out between $6,000 and $12,000. Mutual P&C companies that during the taxable year receive a gross amount of not more than $150,000 from premiums and certain investment income are also exempt from tax, regardless of the amount of their taxable income. Unless they elect to the contrary, companies that receive a gross amount from premiums and certain investment income of more than $150,000 but not more than $500,000 are taxed only on their investment income (and are not taxed at all if their investment income is not more than $3,000); their underwriting income is exempt from tax. A limitation on the rate of tax on the investment income of such companies in excess of $3,000 phases out between $3,000 and $6,000. A further reduction of the rate of tax on the investment income of such companies phases out as the gross amount from premiums and certain investment income increases from $150,000 to $250,000. Finally, mutual P&C companies that receive a gross amount from premiums and certain investment income of less than $1,100,000 are allowed a special deduction against their underwriting income (if it is subject to tax). The maximum amount of the deduction is $6,000, and the deduction phases out as the gross amount increases from $500,000 to $1,100,000.

Reasons for Change

The special tax rules that reduce or eliminate the tax liability of certain small mutual P&C companies provide competitive advantages to those companies vis-a-vis stock companies and larger mutual companies. The application of these rules requires arbitrary distinctions between underwriting and investment income, thereby increasing the complexity of the tax code.

Proposal

The special tax exemptions, rate reductions, and deductions of small mutual P&C companies would be repealed.

Effective Date

The proposal would be phased in over a five-year period, starting with the first taxable year beginning on or after January 1, 1986.

Analysis

Small mutual P&C companies would be placed on a par with all other small corporations. Elimination of preferential rates based on the size of the firm (other than the graduated rates made available to small corporations generally) would reduce tax-induced distortions that favor the sale of insurance through small firms.

LIMIT MUTUAL PROPERTY AND CASUALTY INSURANCE COMPANY DEDUCTION FOR POLICYHOLDER DIVIDENDS

General Explanation

Chapter 10.13

Current Law

In general, stock and mutual property and casualty ("P&C") insurance companies are allowed to deduct dividends and similar distributions paid or declared to policyholders in their capacity as such. These distributions are treated by policyholders as price rebates rather than as taxable distributions. Dividends paid by stock P&C companies to their shareholders are not deductible by the company and are includable in the gross income of the recipient.

In the case of life insurance companies, the amount of the deduction allowed mutual companies for policyholder dividends is subject to certain limitations. The deductibility constraint stems from a recognition that policyholder dividends paid by mutual companies are, to some extent, distributions of the companies' earnings to policyholders in their capacity as owners of the company. Consequently, the deduction for policyholder dividends is reduced by an amount determined to be the owner/policyholder's share of the distributed earnings of the company.

Reasons for Change

The different tax treatment of income distributed in the form of policyholder dividends by mutual P&C companies and shareholder dividends paid by stock P&C companies provides a competitive advantage to mutual P&C companies vis-a-vis stock P&C companies and other corporations. This competitive advantage of mutual companies was recognized in the 1984 overhaul of the life insurance company tax rules, which imposed a limitation on the deductibility of policyholder dividends by mutual life insurance companies. A similar limitation on the deductibility of mutual P&C company policyholder dividends would reduce the distortion caused by the deduction and by the policyholders' treatment of the dividends as price rebates.

Proposal

The deduction for policyholder dividends allowed mutual P&C companies would be reduced in a manner similar to the way in which the deduction for policyholder dividends allowed mutual life insurance companies is reduced under current law. Additional study is needed to determine the size of the competitive advantage that the current treatment of policyholder dividends provides to mutual P&C companies and to set the appropriate deduction limitation.

Effective Date

The proposal would be effective for taxable years beginning on or after January 1, 1986.

Analysis

The proposal would subject all income of mutual P&C companies, including profits distributed to policyholders, to tax at the company level. Mutual companies may distribute a lesser amount of policyholder dividends and charge slightly higher premiums as a result of the tax on equity income, similar to the effect of corporate taxes on other companies. The advantage of mutual companies over stock companies would be reduced, as would the advantage of mutual P&C companies selling insurance products in competition with life insurance companies.